2004-2005
Budget

Correcting Fiscal Imbalance

Québec

104-03813/

2004-2005
Budget

Correcting Fiscal Imbalance

Finances Québec

2004-2005 Budget
Correcting Fiscal Imbalance

ISBN 2-550-42381-X
Legal deposit
Bibliothèque nationale du Québec, 2004
Publication date: March 2004
© Gouvernement du Québec, 2004

TABLE OF CONTENTS

TABLE OF CONTENTS I

LIST OF TABLES, CHARTS AND DIAGRAMS II

MESSAGE FROM THE MINISTER OF FINANCE III

INTRODUCTION 1

1. FEDERAL TRANSFERS ARE UNDERMINING QUÉBEC'S FINANCES 3

1.1 Recent changes in federal transfers 3
1.2 Measures to defer the impact of the decline in federal transfers 5

2. EQUALIZATION: A MAJOR REFORM IS NEEDED 9

2.1 The standard is still inadequate 10
2.2 An arbitrary solution to correct major weaknesses in the property tax base 13
2.3 Coverage of provincial revenues remains incomplete 17
2.4 The smoothing mechanism delays improvements to the equalization program 18
2.5 Financial impact of Québec's proposals 20

3. HEALTH: THE FEDERAL CONTRIBUTION OF 16% IS INSUFFICIENT 21

4. CORRECT THE FISCAL IMBALANCE 25

4.1 Acknowledge the existence of the fiscal imbalance 25
4.2 Negotiate equalization and health funding at the same time 29
4.3 Corrective measures to be implemented gradually 31

APPENDIX: HOW EQUALIZATION WORKS 33

1. Canada's equalization program 33
2. Calculation of equalization entitlements 34

LIST OF TABLES, CHARTS AND DIAGRAMS

TABLE 1	FEDERAL TRANSFERS TO QUÉBEC, BEFORE DEFERRAL AND AVERAGING OF THE DECLINE	3
TABLE 2	IMPACT ON QUÉBEC OF THE FEBRUARY 2003 FEDERAL ANNOUNCEMENT ON HEALTH	5
TABLE 3	IMPACT ON QUÉBEC OF MEASURES TO DEFER AND AVERAGE THE DECLINE IN FEDERAL TRANSFERS	7
TABLE 4	FINANCIAL IMPACT OF QUÉBEC'S PROPOSALS, 2004-2005	20
TABLE 5	IMPACT ON QUÉBEC OF THE PROPOSALS OF THE FEDERAL GOVERNMENT AND QUÉBEC REGARDING THE RENEWAL OF EQUALIZATION	20
TABLE 6	BUDGETARY BALANCES OF THE PROVINCES AND TERRITORIES	26
TABLE 7	FEDERAL GOVERNMENT SURPLUS AFTER ITS NEW SPENDING AND TAX CUT INITIATIVES	28
TABLE 8	IMPACT OF A RISE OF $1 BILLION IN THE CHST FUNDED BY AN EQUIVALENT DROP IN EQUALIZATION	31
TABLE 9	IMPACT OF PROPOSALS FOR HEALTH FUNDING AND THE RENEWAL OF EQUALIZATION, 2004-2005 TO 2009-2010	31
TABLE A1	EQUALIZATION ENTITLEMENTS FOR QUÉBEC, ONTARIO AND THE RECIPIENT PROVINCES, 2003-2004	37

CHART 1	QUÉBEC'S EQUALIZATION PAYMENTS, BEFORE DEFERRAL AND AVERAGING OF THE DECLINE	4
CHART 2	EQUALIZATION ENTITLEMENTS AND IMPACT OF THE REFUNDABLE FLOOR MECHANISM ON QUÉBEC IN 2004-2005	6
CHART 3	QUÉBEC'S FISCAL CAPACITY BEFORE AND AFTER EQUALIZATION	11
CHART 4	FISCAL CAPACITY FOR OIL AND GAS RESOURCES AND WATER POWER RESOURCES	11
CHART 5	RESIDENTIAL PROPERTY VALUES AND CURRENT RESIDENTIAL TAX BASE FOR EQUALIZATION	16
CHART 6	CHANGE IN QUÉBEC'S EQUALIZATION REVENUE FROM 1990-1991 TO 2003-2004	18
CHART 7	FEDERAL CONTRIBUTION TO FUNDING OF PROVINCIAL AND TERRITORIAL SPENDING ON HEALTH, EDUCATION AND SOCIAL SERVICES	22
CHART 8	PREMIERS' PROPOSAL REGARDING THE FEDERAL CONTRIBUTION TO HEALTH FUNDING	24
CHART 9	BUDGETARY BALANCES OF THE FEDERAL GOVERNMENT AND THE PROVINCES AND TERRITORIES AS A WHOLE, 2001-2002 TO 2019-2020	27
CHART A1	EQUALIZATION AS A PROPORTION OF PROVINCIAL BUDGETARY REVENUES, 2002-2003	34
CHART A2	PROVINCES' FISCAL CAPACITY, BEFORE AND AFTER EQUALIZATION, 2003-2004	38

DIAGRAM 1	CURRENT FORMULA FOR THE RESIDENTIAL PORTION OF THE PROPERTY TAX BASE	14
DIAGRAM 2	FEDERAL PROPOSAL FOR SMOOTHING EQUALIZATION ENTITLEMENTS	19
DIAGRAM 3	FEDERAL PROPOSAL FOR THE GRADUAL IMPLEMENTATION OF THE 2004 RENEWAL OF EQUALIZATION	19
DIAGRAM 4	PROJECTIONS OF THE FEDERAL DEBT	28
DIAGRAM A1	EQUALIZATION ENTITLEMENTS CALCULATION FORMULA	35
DIAGRAM A2	CALCULATION OF QUÉBEC'S EQUALIZATION ENTITLEMENTS FOR THE TOBACCO TAX BASE, 2003-2004	36

MESSAGE FROM THE MINISTER OF FINANCE

Some time ago, I had the pleasure of chairing the Commission on Fiscal Imbalance set up by the Québec government. In addition to showing that a significant fiscal imbalance exists within the Canadian federation and proposing solutions to correct it, the Commission clearly identified weaknesses in federal transfers to the provinces as one of the main causes of this imbalance.

As Minister of Finance, I am now in a better position than ever to speak of the constraints federal transfers impose on Québec's public finances. Changes in these revenues are undermining Québec's public finances, particularly in 2003-2004 and 2004-2005. In this context, I had to negotiate the implementation of emergency measures with my federal colleague to delay the impact of negative adjustments to equalization. However, these measures do not correct the basic flaws that afflict federal transfer programs and produce no lasting financial gain for Québec.

In its recent budget, the federal government announced the proposed changes it intends to make to the equalization program for the next five years. Québec and the other recipient provinces consider that, in many regards, the federal proposals are inadequate. The changes being contemplated do not significantly reduce the substantial disparities among the provinces in capacity to fund public services and consequently, do not enable the equalization program to achieve the objective written into section 36(2) of the Constitution.

Lastly, discussions with the federal government on long-term federal health funding will intensify over the coming months, culminating in a First Ministers' Conference this summer. Despite the federal government's recent reinvestments, its contribution to health funding is now only 16% of provincial spending. This is clearly insufficient in view of the federal government's initial commitment to fund 50% of these expenditures, the enormous surpluses available to it and, above all, the priority Quebecers and Canadians place on health.

Given the importance of these issues, I felt it was essential, as part of the 2004-2005 Budget Speech, *to provide the facts on these matters, which is why I am releasing this paper.*

Yves SÉGUIN

INTRODUCTION

Correct the Fiscal Imbalance takes stock of recent developments concerning federal transfers to Québec and the broader issue of the various fiscal imbalances in Canada, first between the federal government and the provinces, but also among the provinces themselves.

The first section explains the major decline in federal transfers to Québec between 2002-2003 and 2004-2005 and describes the measures implemented to defer part of the impact of this reduction on the Québec government's financial framework.

Section two deals with the issues raised by the renewal of the equalization program. This program is reviewed once every five years as part of a process under which the federal government and the provinces identify and discuss improvements to the program. The changes to the program are to take effect on April 1, 2004. In this context, the federal government submitted its proposed reforms last March 23. A bill giving effect to the proposed changes will be tabled in the federal Parliament shortly.

The third section discusses federal health funding over the last number of years. It also sets out the unanimous proposals of the provinces and territories concerning the federal financial contribution for health, in the context of next summer's First Ministers' Conference.

The final section explains the need to negotiate improvements to the equalization program and to federal health funding at the same time, to ensure that the less affluent provinces have, like the more affluent provinces, the financial resources they need to deliver quality public services, particularly in health.

1. FEDERAL TRANSFERS ARE UNDERMINING QUÉBEC'S FINANCES

Federal transfers to Québec would have fallen dramatically in 2003-2004 and 2004-2005 had special mechanisms not been implemented to defer part of the impact of the decline to subsequent years. This section discusses the changes in the Québec government's transfer revenues, describes the factors responsible for the decline in revenue and the mechanisms negotiated with the federal government.

1.1 Recent changes in federal transfers

Table 1 shows the Québec government's revenue from federal transfers without measures to defer the impact of the expected decline to future years. In 2003-2004, had nothing been done, federal transfers would have fallen by $716 million compared to 2002-2003. In addition, federal transfers would have dropped by a further $940 million in 2004-2005, to $7.3 billion. Accordingly, federal transfers would have fallen by $1.7 billion between 2002-2003 and 2004-2005.

TABLE 1
FEDERAL TRANSFERS TO QUÉBEC, BEFORE DEFERRAL AND AVERAGING OF THE DECLINE
(Excluding consolidated organizations, millions of dollars)

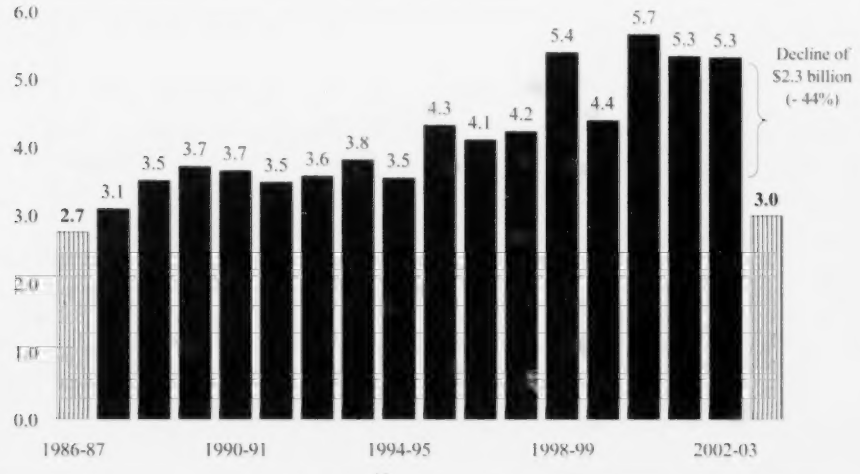
	2002-2003	2003-2004	2004-2005
Federal transfers	8 932	8 216	7 276
% change	*0.5*	*- 8.0*	*- 11.4*
Including:			
Equalization	5 315	2 991	3 800
% change	*- 0.4*	*- 43.7*	*27.0*
Canada Health and Social Transfer (CHST)	2 648	4 179	2 832
% change	*- 10.5*	*57.8*	*- 32.2*

Source: Ministère des Finances du Québec.

Significant drop in equalization in 2003-2004

Had no measures been taken, the $1.6-billion increase in the Canada Health and Social Transfer (CHST) in 2003-2004 stemming from the February 2003 federal announcement on health would have been more than offset by a drop in equalization of $2.3 billion. At $3 billion, equalization revenue would have fallen by a historic 44% to its lowest level since 1986-1987.

CHART 1
QUÉBEC'S EQUALIZATION PAYMENTS, BEFORE DEFERRAL AND AVERAGING OF THE DECLINE
(Billions of dollars)



Source: Ministère des Finances du Québec.

The significant drop in equalization payments Québec would have suffered in 2003-2004 reflects the relative strength of its economy in 2002[1] and, especially, the very high volatility in the program's payments.

1 Equalization payments in 2003-2004 depend mainly on economic and tax variables for 2002. A brief explanation of how the equalization program works is given in the appendix.

Additional federal funds for health non-recurring in 2004-2005

Despite a recovery in equalization revenue, federal transfers will decline once again in 2004-2005 because the bulk of the additional investments in health announced by the federal government in February 2003 is non-recurring. After generating $1.6 billion in revenue in Québec in 2003-2004, the impact of the federal announcement will be no more than $352 million in 2004-2005, i.e. a decline of $1.3 billion.

TABLE 2
IMPACT ON QUÉBEC OF THE FEBRUARY 2003 FEDERAL ANNOUNCEMENT ON HEALTH
(Millions of dollars)

	2003-2004	2004-2005
Health Reform Fund	**236**	**352**
Non-recurring trusts		
▪ CHST supplement of $2.5 billion	587	—
▪ Medical and Diagnostic Equipment Fund	352	—
▪ CHST supplement of $2 billion	471	—
Subtotal	1 410	—
Total	**1 646**	**352**

Source: Ministère des Finances du Québec.

1.2 Measures to defer the impact of the decline in federal transfers

As soon as the decline in equalization revenue became clear, for 2003-2004 and for 2004-2005, the Québec government initiated discussions with the federal government to mitigate its impact. These discussions led to the implementation of specific solutions for each of these two years. It should be noted that all the provinces can take advantage of the mechanisms put in place.

2003-2004: deferral and averaging of part of the downward adjustment to equalization and the CHST

In 2003-2004, as indicated above, the drop in equalization revenue reflects especially the change in personal income tax and corporate income tax data. Some provinces were also severely affected by population data of the 2001 census.

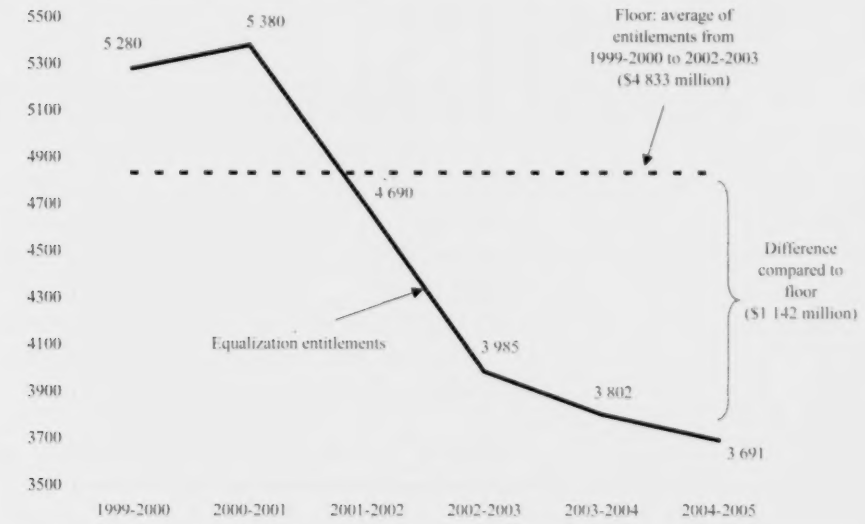
In this context, the federal government agreed to defer and average over five years, beginning in 2005-2006, repayment of the drop in federal transfers between the federal estimates of October 2003 and February 2004 arising from these three sources of adjustments. In 2003-2004, this measure will enable Québec to defer repayment of $1 161 million.

2004-2005: implementation of a refundable floor for equalization

Concerning 2004-2005, the federal government agreed to set up a "refundable floor" mechanism for equalization. According to this mechanism, Québec's equalization entitlements for 2004-2005 cannot be less than the average entitlements for the years 1999-2000 to 2002-2003. The difference between this floor and entitlements for 2004-2005 can be refunded over five years beginning in 2005-2006.

In 2004-2005, on the basis of the latest federal estimates, this mechanism will enable Québec to defer $1 142 million.

CHART 2
EQUALIZATION ENTITLEMENTS AND IMPACT OF THE REFUNDABLE FLOOR MECHANISM ON QUÉBEC IN 2004-2005
(Millions of dollars)



Source: Department of Finance Canada.

Financial impact

The introduction of these two mechanisms will raise federal transfers to Québec by $1.2 billion in 2003-2004 and in 2004-2005. However, Québec will have to repay the federal government $472 million per year for five years starting in 2005-2006. Accordingly, Québec derives no lasting financial gain from these mechanisms.

TABLE 3
IMPACT ON QUÉBEC OF MEASURES TO DEFER AND AVERAGE THE DECLINE IN FEDERAL TRANSFERS
(Excluding consolidated organizations, millions of dollars)

	Federal transfers before measures	2003-2004 deferral	2004-2005 refundable floor	Impact of measures	Federal transfers after measures
2003-2004	8 216	1 161	—	1 161	9 377
2004-2005	7 276	58[1]	1 142	1 200	8 476
2005-2006	8 348	- 244	- 228	- 472	7 876
2007-2008	n. a.	- 244	- 228	- 472	n. a.
2008-2009	n. a.	- 244	- 228	- 472	n. a.
2009-2010	n. a.	- 244	- 228	- 472	n. a.
2010-2011	n. a.	- 244	- 228	- 472	n. a.
Total	—	**0**	**0**	**0**	—

1 Because of the payment mechanics of the CHST, part of the adjustments for 2003-2004 was already deferred to 2004-2005. The deferral of the adjustments for 2003-2004 accounts for the gain of $58 million in 2004-2005.

n.a. Not available.

Sources: Ministère des Finances du Québec; Department of Finance Canada.

Measures that fail to correct the basic weaknesses of transfer programs

The mechanisms implemented by the federal government are emergency measures that will prevent the excessive volatility of these transfers from undermining the finances of the Québec government and other provincial governments. However, they do nothing to correct the basic weaknesses of transfer programs, either equalization or the CHST. The following sections review the issues surrounding the renewal of equalization and federal health funding.

2. EQUALIZATION: A MAJOR REFORM IS NEEDED

The equalization program is a cornerstone of the Canadian federation. Its objective is clear: enable all provinces to offer public services of comparable quality throughout Canada at comparable levels of taxation. Regular adjustments to the program are needed if equalization is to truly achieve this objective. These adjustments are made every five years. The official deadline for the current renewal is April 1, 2004.[2]

The federal budget of last March 23 contained the changes to the equalization program proposed by the federal government. From Québec's standpoint, these proposals are not enough to adequately correct the major weaknesses of the program, particularly regarding:

— the definition of the standard;

— the measure of fiscal capacity for property taxes;

— coverage of provincial revenues, particularly regarding user fees.

In addition, the corrections would be implemented gradually, i.e. the provinces would have to wait until 2007-2008 to derive full benefit from the impact of these improvements that, moreover, are inadequate.

2 The federal government has given a commitment that the changes will be retroactive to April 1, 2004 even if the House of Commons adopts them after that date.

2.1 The standard is still inadequate

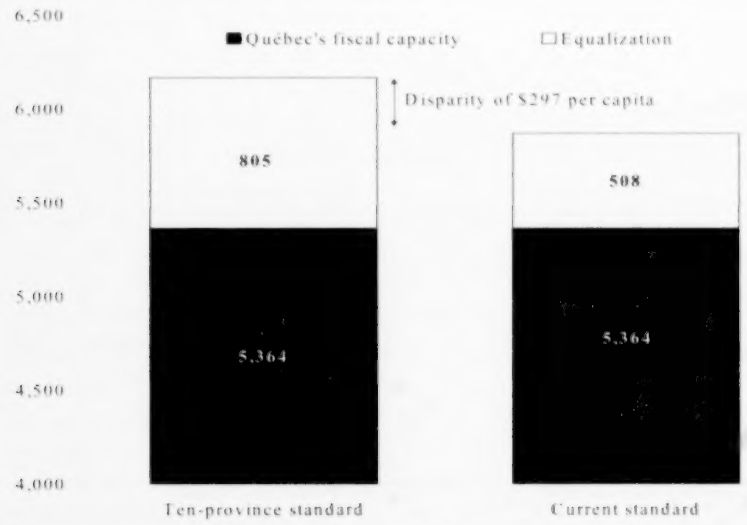
The proposals tabled by the federal government contain no improvement to the standard of the equalization program. The standard is a key parameter of the program: the fiscal capacity of each province is compared with the standard to establish its degree of relative wealth.

This parameter has been changed a few times since the creation of the equalization program in 1957. Initially, the fiscal capacity of the two wealthiest provinces, Alberta and Ontario, formed the standard. The ten-province standard was in effect from 1967 to 1982, when the current five-province standard (Québec, Ontario, Manitoba, Saskatchewan and British Columbia) was adopted.

Québec considers that the existing standard does not allow the program to achieve its constitutional objective. The amounts currently paid by the federal government do not allow the recipient provincial governments to "provide reasonably comparable levels of public services at reasonably comparable levels of taxation", as stipulated in section 36(2) of the Constitution Act, 1982.

Even after equalization, recipient provinces have $297 per capita less than the average of the ten provinces to provide public services in their fields of jurisdiction. This disparity of $297 per capita has significant financial consequences. It means that Québec must maintain an additional burden of over $2 billion to offer a level of public services comparable to the Canadian average. This amount represents 40% of Québec's tax burden differential with Ontario for the personal income tax base ($4.8 billion in 2003).

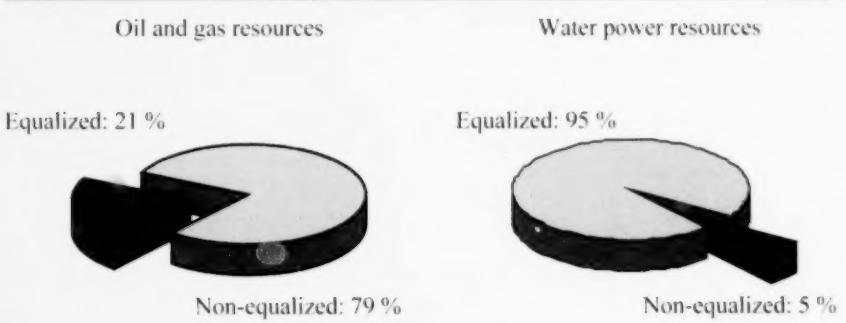
CHART 3
QUÉBEC'S FISCAL CAPACITY BEFORE AND AFTER EQUALIZATION, 2003-2004
(Dollars per capita)



Source: Department of Finance Canada.

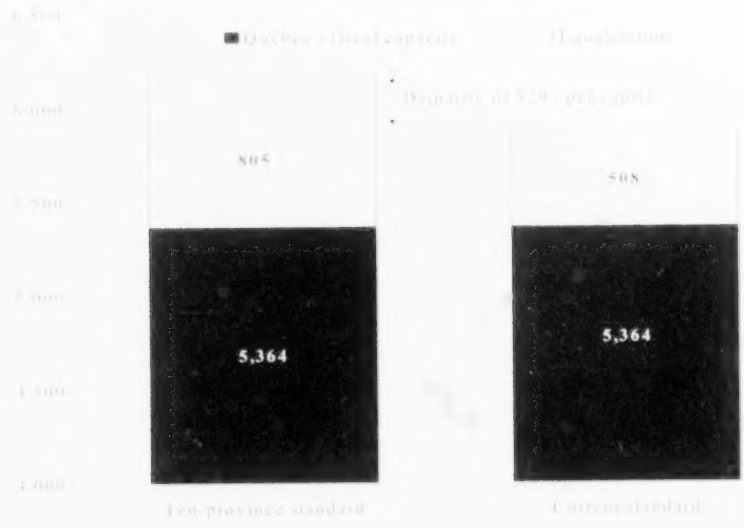
In addition, the current standard prevents a fair comparison of the provinces' tax sources. For instance, only 21% of the fiscal capacity of the oil and gas resources field in Canada is subject to equalization because these resources are found mainly in Alberta and in certain Atlantic provinces that have been excluded from the standard since 1982. On the other hand, 95% of the fiscal capacity arising from water power is included in the standard because a high proportion of this source is present in Québec

CHART 4
FISCAL CAPACITY FOR OIL AND GAS RESOURCES AND FOR WATER POWER RESOURCES
(Per cent)



Source: Department of Finance Canada.

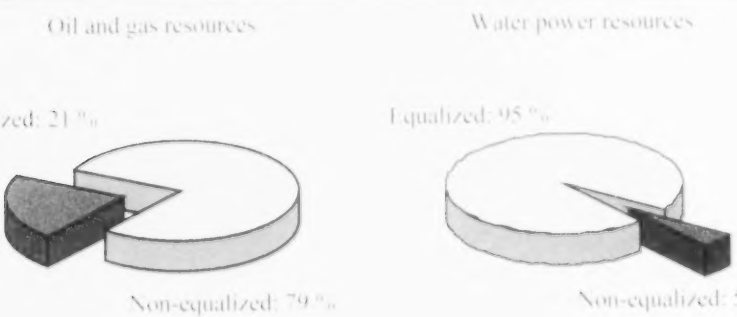
CHART 3
QUÉBEC'S FISCAL CAPACITY BEFORE AND AFTER EQUALIZATION, 2003-2004
(Dollars per capita)



Source: Department of Finance Canada.

In addition, the current standard prevents a fair comparison of the provinces' tax sources. For instance, only 21% of the fiscal capacity of the oil and gas resources field in Canada is subject to equalization because these resources are found mainly in Alberta and in certain Atlantic provinces that have been excluded from the standard since 1982. On the other hand, 95% of the fiscal capacity arising from water power is included in the standard because a high proportion of this source is present in Québec.

CHART 4
FISCAL CAPACITY FOR OIL AND GAS RESOURCES AND FOR WATER POWER RESOURCES
(Per cent)



Source: Department of Finance Canada.

The ten-province standard is the best option for replacing the existing standard. It was recommended by the Commission on Fiscal Imbalance,[3] by many provinces and by the Standing Senate Committee on National Finance:[4]

> *The Committee feels that a five-province standard does not fulfil the intent of the program, which is to provide adequate funding that allows the provinces to provide comparable services to their residents.*
>
> *(...) while the five-province standard may have saved the federal government $31 billion in the past two decades, it has also imposed a burden on the recipient provinces that has translated into reduced services for some Canadians. Consequently, the Committee recommends that the federal government restore the ten-province standard in determining provincial entitlements under the Equalization program.*

Consequently, Québec asks the federal government to reconsider its position and base the equalization program on the average wealth of the ten provinces as part of the 2004 renewal. Failure to do so will deprive Québec of annual revenue of more than $2 billion, i.e. close to $11 billion over the next five years.

3 Commission on Fiscal Imbalance, "A New Division of Canada's Financial Resources", March 2002.
4 Standing Senate Committee on National Finance, "The Effectiveness of and Possible Improvements to the Present Equalization Policy", March 2002.

2.2 An arbitrary solution to correct major weaknesses in the property tax base

Since 1982, all provincial and municipal property tax revenue is subject to equalization. Today, this tax base is the program's second largest, covering revenue of more than $35 billion.

Weaknesses of the current property tax base

Rather than measuring fiscal capacity for this tax base using residential market property values, which is what provincial and municipal taxation practices are based on, the current, so-called "multi-concept" equalization formula is based on a set of economic and demographic variables linked by complex mathematical relations that are chosen arbitrarily.

The calculation of this tax base is particularly complex and involves a large number of ad hoc adjustments, as indicated by the following diagram that shows only the residential portion.

DIAGRAM 1
CURRENT FORMULA FOR THE RESIDENTIAL PORTION OF THE PROPERTY TAX BASE

The equalization regulations define the residential tax base as follows:

$$\left[YPDA_i + \left(\frac{YPDA_{10} * POPFUM_i}{POPFUM_{10}}\right) + \left(\frac{YPDA_{10} * \Delta POP_i}{\Delta POP_{10}}\right)\right] * \left[\frac{0.5216 * K^R_{10}}{\sum_{1}^{10}\left[YPDA_i + \left(\frac{YPDA_{10} * POPFUM_i}{POPFUM_{10}}\right) + \left(\frac{YPDA_{10} * \Delta POP_i}{\Delta POP_{10}}\right)\right]}\right] + K^R_i$$

where:

$YPDA_i$ is the value of personal disposable income for the calendar year ending during the preceding fiscal year, less provincial and local indirect taxes for such year, other than provincial and local property taxes, taxes on legal persons other than those on profits, fees paid by businesses for motor vehicle registration and licenses, various taxes on natural resources and provincial and local taxes on the sales price and value of real property at the time of transfer, in each province, determined by Statistics Canada for its provincial economic accounts;

$POPFUM_i$ is the product of the province's population for the preceding fiscal year multiplied by the urbanization factor:

a) 0.580172 for Newfoundland,
b) 0.513686 for Prince Edward Island,
c) 0.695930 for Nova Scotia;
d) 0.508889 for New Brunswick,
e) 1.101451 for Québec,
f) 1.401872 for Ontario,
g) 0.900259 for Manitoba,
h) 0.614636 for Saskatchewan,
i) 0.953147 for Alberta,
j) 1.432534 for British Columbia;

$\left(\frac{YPDA_{10}}{POPFUM_{10}}\right)$ is the fraction in which the numerator is the sum, for the ten provinces, of the $YPDA_i$ and the denominator is the sum, for the ten provinces, of the $POPFUM_i$;

ΔPOP_i is the change in the province's population, including the estimated number of non-permanent residents, for the preceding fiscal year, less the province's population, including the estimated number of non-permanent residents, for the fiscal year five years prior to such preceding fiscal year;

$\left(\frac{YPDA_{10}}{\Delta POP_{10}}\right)$ is the fraction in which the numerator is the sum, for the ten provinces, of the YPDAj and the denominator is the sum, for the ten provinces, of the ΔPOP_i;

$\frac{0.5216 * K^R_{10}}{\sum_{1}^{10}\left[YPDA_i + \left(\frac{YPDA_{10} * POPFUM_i}{POPFUM_{10}}\right) + \left(\frac{YPDA_{10} * \Delta POP_i}{\Delta POP_{10}}\right)\right]}$ is the fraction in which the numerator is the product of 0.5216 multiplied by the sum of the K^R of the provinces, and the denominator is the sum, for the ten provinces, of terms whose components are defined above;

K^R_i is the value of the province's net stock of residential capital, measured in current dollars, at the end of the calendar year ending during the preceding fiscal year, such value being determined by Statistics Canada for its estimates regarding flows and stocks of fixed capital.

The current tax base is not representative of taxation practices in Canada. This is a basic defect in an equalization program that measures fiscal capacity for all sources of revenue on the basis of the actual practices of the provinces.

The current property tax base uses inadequate data

The weaknesses of the current property tax base are also shown by its extreme sensitivity to data of very low quality. The "building" component of the formula for the residential sector is estimated using the stock of residential capital calculated by Statistics Canada for the national accounts. In December 2001, a seemingly minor change in the methodology for calculating this variable had a major redistributive impact on equalization.

Québec is currently repaying $655 million to the federal government because of the unforeseen impact of this change in methodology in 2001-2002 and 2002-2003 in addition to losing roughly $185 million per year since then. This prompted Québec to undertake a more thorough study of the methodology used by Statistics Canada to calculate these new data, which revealed the extent to which the use of such data is inappropriate for the purposes of calculating equalization entitlements.[5]

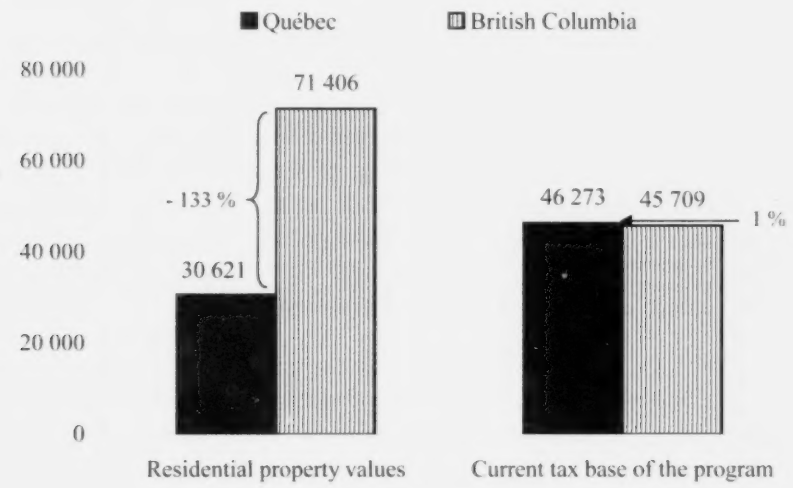
The current property tax base produces false results

Beyond its technical and methodological weaknesses, the current property tax base produces counter-intuitive and, especially, false results. Using this tax base, the province with the highest property value per capita in Canada, British Columbia, is receiving almost $400 million in equalization for this source of revenue in 2003-2004. The current tax base "measures" fiscal capacity in Québec that is 1% higher than in British Columbia although the average property value in British Columbia is 133% greater than in Québec.

5 In this regard, see "Measuring Net Capital Housing Stock: Critical Analysis of the Perpetual Inventory Method", Institut de la statistique du Québec, May 2002.

CHART 5
RESIDENTIAL PROPERTY VALUES AND CURRENT RESIDENTIAL TAX BASE FOR EQUALIZATION

(Dollars per capita)



Sources: Department of Finance Canada; 2002 assessment rolls.

The federal proposal

In the proposals it tabled last March 23, the federal government agreed, for the most part, with the arguments Québec has raised over more than twenty years and it acknowledges that the residential property tax base must be based on the market values appearing in municipal assessment rolls.

However, the federal government is proposing that the new property tax base be a 50-50 amalgam of the current tax base and property values. This postpones implementation of a tax base consisting exclusively of property values to the 2009 renewal. This means that the existing tax base, with its well-documented weaknesses, would continue to be a major factor in the equalization of property taxes for at least another five years.

Québec considers this to be a totally arbitrary solution that simply delays the implementation of changes that would help the program be more effective in achieving its objective. Consequently, Québec requests that the residential property tax base rely exclusively on residential market values as of 2004-2005. Failure to do so will deprive Québec of revenue of up to $2 billion over the next five years.

2.3 Coverage of provincial revenues remains incomplete

Since the 1999 renewal, the equalization formula includes only 50% of revenues from sales of goods and services by public administrations, sometimes referred to as "user fees". This reduces the equalization entitlements of the recipient provinces by about $500 million in 2004-2005, including $144 million for Québec.

To prevent the equalization program from having pernicious effects on the provinces' choices of funding methods for public services, it must cover all provincial revenues. Funding of a public service is currently subject to equalization when it takes the form of tax revenues, but is partially excluded when it consists of user fees, which reduces the equalization revenues of the provinces.

The provinces are accordingly penalized when they use this funding method for public services. Yet user fees are often an economically efficient way to fund certain public services. As a result, the provinces are discouraged from adopting good public policies.

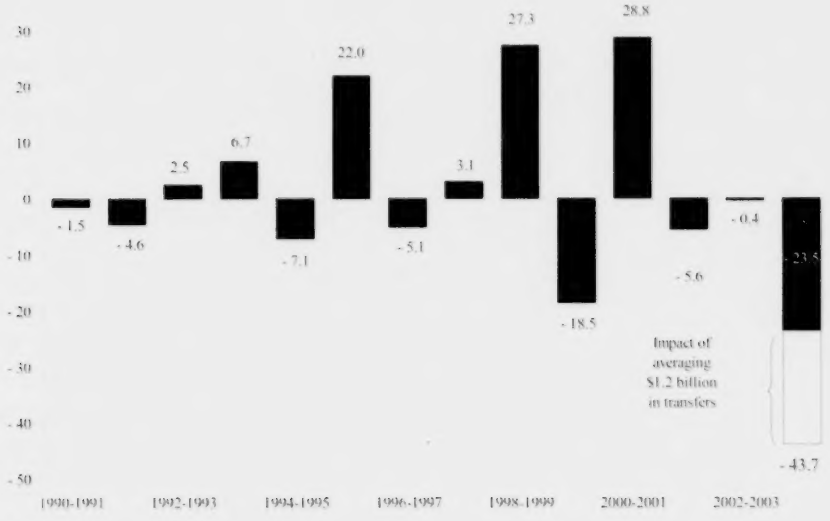
The federal government has acknowledged the soundness of this argument and has proposed that the status quo be maintained for the 2004 renewal rather than withdrawing the remaining 50% of revenue from the sales of goods and services from the program, as it had suggested in technical discussions among officials. However, the federal reasoning in favour of maintaining the status quo leads straight to the conclusion that all user fees should be subject to equalization, as was the case prior to 1999.

Québec therefore requests that the federal government be consistent with its reasoning and include, as of 2004-2005, all user fees in the calculation of equalization. Failure to do so will deprive Québec of almost $800 million of revenue over the next five years.

2.4 The smoothing mechanism delays improvements to the equalization program

The volatility of equalization revenues is another very important issue for Québec. In recent years, and particularly in 2003-2004, the equalization revenues of Québec and other provinces have been highly volatile, making sound budgetary planning extremely difficult.

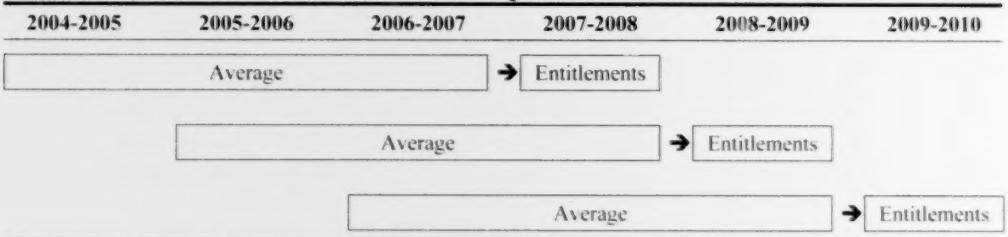
CHART 6
CHANGE IN QUÉBEC'S EQUALIZATION REVENUE FROM 1990-1991 TO 2003-2004
(Per cent)



Source: Ministère des Finances du Québec.

To reduce this significant variability in equalization revenue, the federal government is proposing to implement a mechanism to smooth entitlements. According to this mechanism, entitlements for each year would be based on the average of the entitlements of the three preceding years.

DIAGRAM 2
FEDERAL PROPOSAL FOR SMOOTHING EQUALIZATION ENTITLEMENTS



However, while implementation of the mechanism proposed by the federal government would appreciably reduce volatility of equalization revenue, it would result in the recipient provinces deriving no financial benefit in 2004-2005 from the program's renewal. Not until 2007-2008 would they benefit fully from the proposed improvements that, moreover, are insufficient.

DIAGRAM 3
FEDERAL PROPOSAL FOR THE GRADUAL IMPLEMENTATION OF THE 2004 RENEWAL OF EQUALIZATION

2004-2005	2005-2006	2006-2007	2007-2008	2008-2009
100% current tax bases	2/3 current tax bases	1/3 current tax bases	100% new tax bases	100% new tax bases
	1/3 new tax bases	2/3 new tax bases		

The recipient provinces have vigorously criticized this major weakness of the smoothing mechanism. In answer to these criticisms, the federal government has decided, totally arbitrarily, to make lump-sum payments of $150 million in 2004-2005 and $25 million in 2005-2006 to the recipient provinces. The payments will be allocated among these provinces on a per capita basis.

For Québec, this kind of ad hoc arrangement is not a valid alternative to the implementation of lasting improvements to the equalization program. On the contrary, Québec believes it is fundamental that the contemplated improvements to the program have an impact starting in 2004-2005 since they seek to correct major weaknesses of the program. Québec is of the view that the smoothing mechanism and the improvements to the program should be in effect in 2004-2005.

2.4 The smoothing mechanism delays improvements to the equalization program

The volatility of equalization revenues is another very important issue for Québec. In recent years, and particularly in 2003-2004, the equalization revenues of Québec and other provinces have been highly volatile, making sound budgetary planning extremely difficult.

CHART 6
CHANGE IN QUÉBEC'S EQUALIZATION REVENUE FROM 1990-1991 TO 2003-2004
(Per cent)

Source: Ministère des Finances du Québec.

To reduce this significant variability in equalization revenue, the federal government is proposing to implement a mechanism to smooth entitlements. According to this mechanism, entitlements for each year would be based on the average of the entitlements of the three preceding years.

DIAGRAM 2
FEDERAL PROPOSAL FOR SMOOTHING EQUALIZATION ENTITLEMENTS

However, while implementation of the mechanism proposed by the federal government would appreciably reduce volatility of equalization revenue, it would result in the recipient provinces deriving no financial benefit in 2004-2005 from the program's renewal. Not until 2007-2008 would they benefit fully from the proposed improvements that, moreover, are insufficient.

DIAGRAM 3
FEDERAL PROPOSAL FOR THE GRADUAL IMPLEMENTATION OF THE 2004 RENEWAL OF EQUALIZATION

2004-2005	2005-2006	2006-2007	2007-2008	2008-2009
100% current tax bases	2/3 current tax bases	1/3 current tax bases	100% new tax bases	100% new tax bases
	1/3 new tax bases	2/3 new tax bases		

The recipient provinces have vigorously criticized this major weakness of the smoothing mechanism. In answer to these criticisms, the federal government has decided, totally arbitrarily, to make lump-sum payments of $150 million in 2004-2005 and $25 million in 2005-2006 to the recipient provinces. The payments will be allocated among these provinces on a per capita basis.

For Québec, this kind of ad hoc arrangement is not a valid alternative to the implementation of lasting improvements to the equalization program. On the contrary, Québec believes it is fundamental that the contemplated improvements to the program have an impact starting in 2004-2005 since they seek to correct major weaknesses of the program. Québec is of the view that the smoothing mechanism and the improvements to the program should be in effect in 2004-2005.

2.5 Financial impact of Québec's proposals

Overall, Québec's proposals would increase its federal transfer revenues for equalization by $2.9 billion in 2004-2005. In addition, all provinces receiving equalization would gain more than $300 per capita, except British Columbia, which would receive $189 per capita. The total cost to the federal government would amount to $5.2 billion.

TABLE 4
FINANCIAL IMPACT OF QUÉBEC'S PROPOSALS, 2004-2005
(Millions of dollars)

	Ten-province standard	Property tax base	Full coverage of revenue	Total	Total ($/capita)	Entitlements after Québec's proposal ($/capita)
Newfoundland and Labrador	138	- 10	39	**168**	323	1 707
Prince Edward Island	37	4	10	**51**	370	2 109
Nova Scotia	251	- 4	45	**291**	311	1 523
New Brunswick	201	- 8	47	**240**	319	1 832
Québec	**2 010**	**718**	**144**	**2 872**	**382**	**916**
Ontario	0	0	0	**0**	0	0
Manitoba	312	70	55	**437**	374	1 486
Saskatchewan	266	58	40	**364**	366	567
Alberta	0	0	0	**0**	0	0
British Columbia	1 119	- 416	87	**790**	189	320
Total	**4 334**	**412**	**466**	**5 212**	**322**	**895**

Source: Ministère des Finances du Québec.

Accordingly, Québec's proposals, which are designed to correct fundamental weaknesses in the equalization program and are supported by a majority of the provinces, would provide it with additional revenues of $15.7 billion over the next five years. This strengthening of the program, which is necessary if it is to achieve its constitutional objective, is much more substantial than the timid reform proposal announced by the federal government in its last budget. The federal reform proposal would increase Québec's equalization revenues by only $1.7 billion over the next five years.

TABLE 5
IMPACT ON QUÉBEC OF THE PROPOSALS OF THE FEDERAL GOVERNMENT AND QUÉBEC REGARDING THE RENEWAL OF EQUALIZATION
(Millions of dollars)

	2004-2005	2005-2006	2006-2007	2007-2008	2008-2009	Total
Federal proposals	70	195	368	554	560	1 747
Québec's proposals	2 872	3 009	3 143	3 282	3 431	15 737

Sources: Department of Finance Canada; ministère des Finances du Québec.

3. HEALTH: THE FEDERAL CONTRIBUTION OF 16% IS INSUFFICIENT

The five-year renewal process of the equalization program gives particular and timely importance to the reforms that must be implemented now to correct the program's shortcomings. However, the issue of federal funding for health and social programs is also at the forefront of federal-provincial relations, especially since the major cuts made by the federal government in the mid-1990s.

From its level of $18.7 billion in 1994-1995, the Canada Health and Social Transfer (CHST) plummeted 33% to $12.5 billion three years later, in 1997-1998. Following recent increases in federal transfers for health and social programs funding, they will reach $24 billion in 2004-2005, barely $5 billion more than where they stood ten years earlier. During the same period, provincial and territorial spending on health, education and social services has risen by $47 billion. This means that provincial social spending has increased ten times more than the CHST over the last ten years.

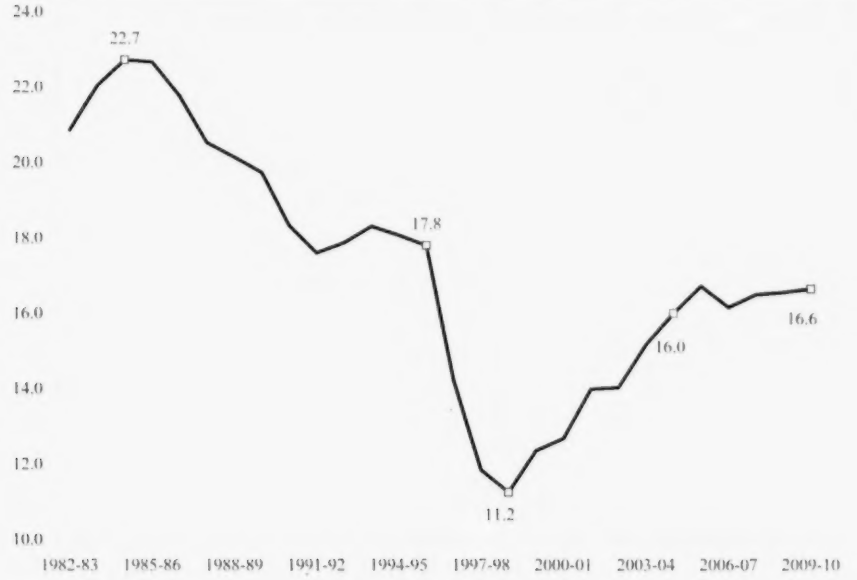
By funding barely 16.0% of provincial social spending in 2004-2005, the federal government is far from the 22.7% achieved in the early 1980s let alone the 50% promised in the initial partnership that gave rise to Canada's basic public health, education and social protection systems in the 1950s and 1960s.

A declining federal contribution, but more control

Despite its financial disengagement and the fact that legally it cannot directly deliver health care, the federal government is trying to assume a growing role in the control and direction of the health care system in Québec and the other provinces.

Since 1984, federal transfers to a province can be reduced if it violates the Canada Health Act. More recently, in its last budget, the federal government confirmed that the Health Council set up in December 2003 "will monitor and make annual public reports on the implementation of the Accord, with an emphasis on its accountability and transparency provisions. The work of the Council will enable Canadians to assess the performance of the health system and the pace of implementation of the various commitments made in the Accord."[6] Note that Québec did not agree with this initiative and will itself report to Quebecers.

CHART 7
FEDERAL CONTRIBUTION TO FUNDING OF PROVINCIAL AND TERRITORIAL SPENDING ON HEALTH, EDUCATION AND SOCIAL SERVICES
(Per cent)



Sources: Department of Finance Canada; provincial and territorial budgets; Conference Board of Canada.

6 2004 federal budget, page 93.

The need for a larger federal contribution has been clearly shown

Numerous commissions have been formed in recent years to study the issue of health reforms. There have been many provincial initiatives, including the Clair Report in Québec in 2000, the Fyke Report in Saskatchewan and the Mazankowski Report in Alberta in 2001. Federal initiatives include the National Forum on Health in 1994, the Kirby Report to the Canadian Senate and the Romanow Report in 2002.

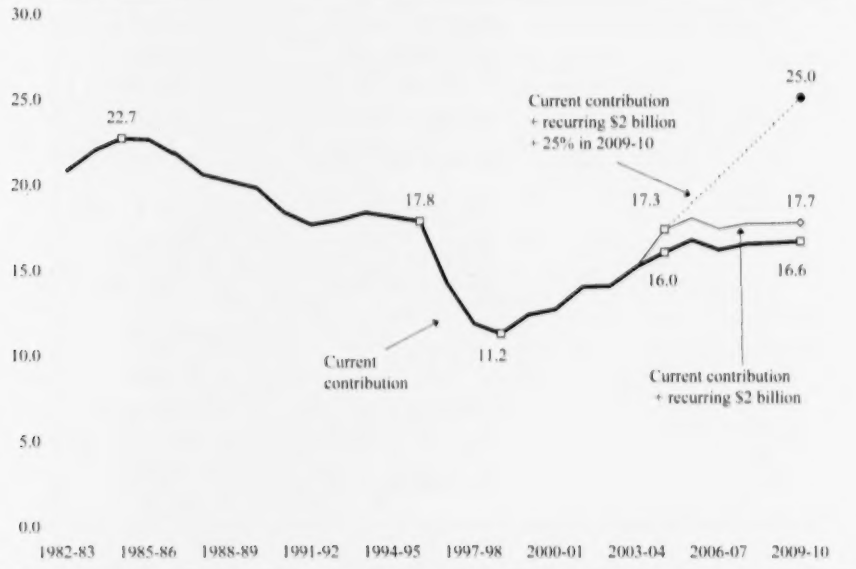
While these studies proposed solutions to the organizational challenges of the health system that at times differed, they all concluded that the federal government needs to raise its financial contribution to the provinces.

In this context, the provincial and territorial premiers unanimously requested, at the meeting of the Council of the Federation on February 23 and 24, 2004, that the federal government make the following two-fold commitment:

— starting in 2004-2005, make recurrent the additional $2 billion announced in February 2003 for 2003-2004;

— thereafter, increase federal transfers to achieve a 25% federal funding share in 2009-2010.

CHART 8
PREMIERS' PROPOSAL REGARDING THE FEDERAL CONTRIBUTION TO HEALTH FUNDING
(Per cent)



Sources: Department of Finance Canada; provincial and territorial budgets; Conference Board of Canada.

For Québec, this proposal represents a gain of $471 million in 2004-2005 that could reach $3.5 billion in 2009-2010.

The real solution: a new division of tax resources

The discussions over the coming months on equalization and health will be extremely important. However, it is clear that the only lasting solution to the problem of fiscal imbalance is to reach a new division of tax resources between the federal government and the provinces. Even though this solution has not been endorsed unanimously by the provinces yet, it is clear, for Québec, that it is the only solution that can finally put an end to the decades-long discussions on funding for social programs.

4. CORRECT THE FISCAL IMBALANCE

The preceding sections have identified the problems that must be resolved as part of the renewal of the equalization program and the coming discussions with the federal government on health funding. Solving these problems would, to a large degree, help correct the fiscal imbalances in the Canadian federation.

This section reiterates the extent of the fiscal imbalance that currently exists between the federal government and the provinces. It also underscores the importance of reinforcing equalization and health funding at the same time, to restore fiscal balance for all the provinces, the less affluent and the more affluent alike.

4.1 Acknowledge the existence of the fiscal imbalance

The 2004-2005 Budget illustrates the significant pressures on the Québec government's financial framework. Despite rigorous management, balancing the budget was not achieved easily in 2004-2005 and an impasse of $1.6 billion has been identified for 2005-2006.

Québec is not the only province facing budget problems. All the provinces, except for Alberta, are facing enormous budgetary difficulties. Accordingly, the provinces and territories as a whole risk recording a deficit of $5.3 billion in 2003-2004. Excluding Alberta, the overall provincial and territorial deficit could reach $8.7 billion.

TABLE 6
BUDGETARY BALANCES OF THE PROVINCES AND TERRITORIES
(Millions of dollars)

	2002-2003	2003-2004
Newfoundland and Labrador	- 691	- 827
Prince Edward Island	- 84	- 53
Nova Scotia	32	- 22
New Brunswick	1	8
Québec	- 694	- 364
Ontario	117	- 5 621
Manitoba	4	5
Saskatchewan	1	0
British Columbia	- 2 680	- 1 644
Yukon	- 6	- 15
Northwest Territories	- 34	- 83
Nunavut	- 22	- 50
Subtotal	**- 4 056**	**- 8 666**
Alberta	2 134	3 327
Total	**- 1 922**	**- 5 339**

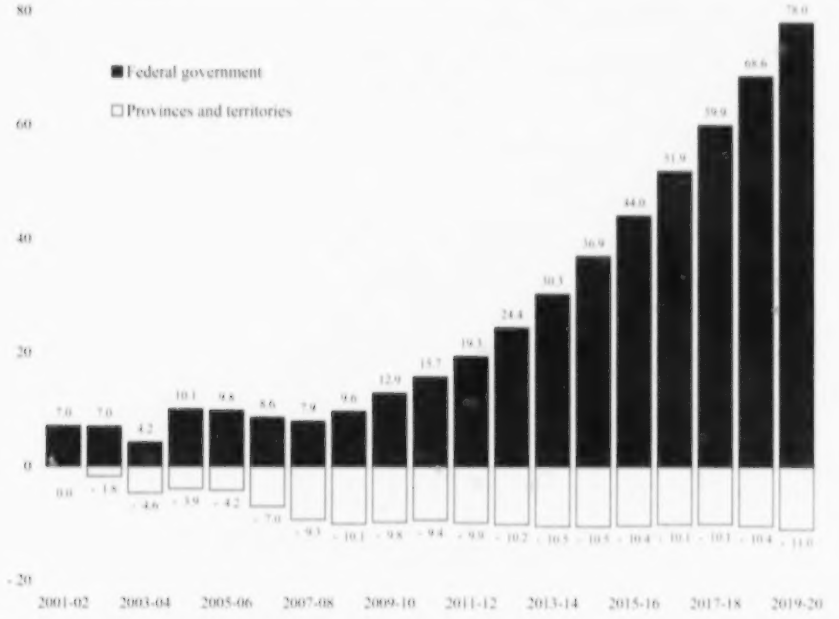
Sources: 2004 federal budget; ministère des Finances du Québec.

The difficulties Québec and most of the other provinces are facing in balancing their financial framework reflect, to a considerable degree, the significant fiscal imbalance between Ottawa and the provinces.

As a whole, governments in Canada collect enough revenue to fund their public services and even satisfy new needs. The problem is that the federal government's share of revenues is too large in relation to its responsibilities and, inversely, the provinces' share is too small.

This conclusion is confirmed by a recent study by the Conference Board of Canada prepared at the request of the Premiers of the provinces and territories. The study concludes that the federal government will record large and growing surpluses over the coming decades. The federal government is expected to achieve a surplus of $10 billion for 2004-2005. This surplus could reach $78 billion in 2019-2020. For their part, the provinces will record substantial deficits that will rise gradually from $4 billion in 2004-2005 to $11 billion in 2019-2020.

CHART 9
BUDGETARY BALANCES OF THE FEDERAL GOVERNMENT AND THE PROVINCES AND TERRITORIES AS A WHOLE, 2001-2002 TO 2019-2020
(Billions of dollars)



Source: *Fiscal Prospects for the Federal and Provincial/Territorial Governments – Update February 2004*, Economic Performance and Trends, Conference Board of Canada, February 2004.

This projection by the Conference Board is consistent with those given in the federal budget last March 23. The federal budget mentions leeway before new initiatives of at least $18.3 billion between 2003-2004 and 2005-2006. However, these surplus forecasts are steeped in the same conservatism that has characterized federal budgets since 1997.

In this regard, it is important to recall that since 1997-1998 the federal government has forecast a balanced budget whereas the final results, as shown in the public accounts, indicate that the federal government actually achieved surpluses totalling $54.1 billion from 1997-1998 to 2003-2004. It is also important to recall that the federal government announced, during this period, new spending and tax cuts each totalling $110 billion. Accordingly, the federal government has systematically under-estimated its leeway in recent years

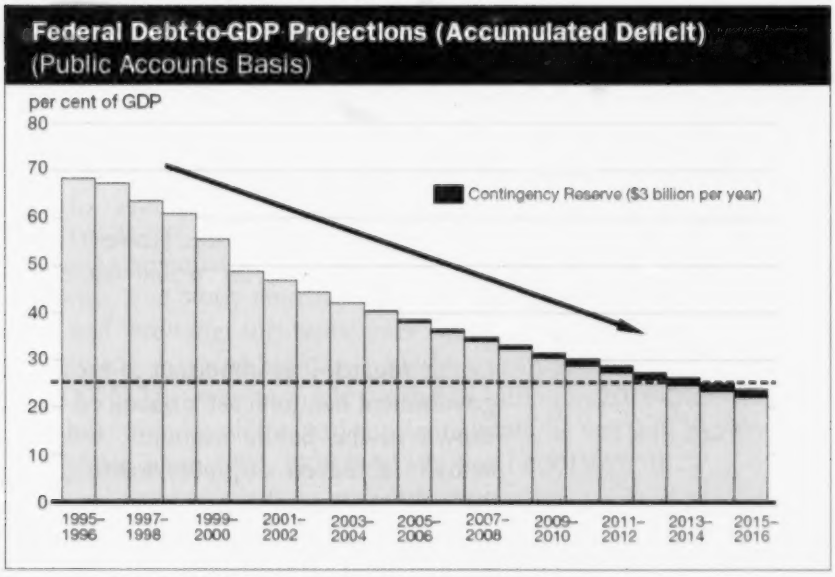
TABLE 7
FEDERAL GOVERNMENT SURPLUS AFTER ITS NEW SPENDING AND TAX CUT INITIATIVES
(Billions of dollars)

	Budgetary balances		New spending	Tax cuts
	Forecast	Actual		
1997-1998	- 17.0	2.1	4.0	0.2
1998-1999	0.0	2.8	7.5	2.1
1999-2000	0.0	13.1	10.6	6.2
2000-2001	0.0	20.2	12.6	14.2
2001-2002	0.0	7.0	18.2	24.2
2002-2003	0.0	7.0	26.9	28.3
2003-2004[P]	0.0	1.9	30.3	34.8
Total	**- 17.0**	**54.1**	**110.1**	**110.0**

P: Preliminary.
Sources: 2003 and 2004 federal budgets.

Furthermore, the federal government, in its last budget, included a projection of its debt as a proportion of the economy until 2015-2016. The similarity between the federal projection and that shown in the February 2004 Conference Board of Canada study is striking.

DIAGRAM 4
PROJECTIONS OF THE FEDERAL DEBT



Source: 2004 federal budget, page 55.

There is no doubt as to the existence of a large fiscal imbalance between the federal government and the provinces. If the Canadian federation is to recover a degree of fiscal balance, the shortcomings described in the last two sections regarding equalization and federal health funding must be corrected at the same time.

4.2 Negotiate equalization and health funding at the same time

Equalization transfers have fallen substantially over the past year. In 2003-2004 they dropped by over $3 billion, with Québec absorbing $2.3 billion of the decline. While equalization is expected to rise for 2004-2005, the amount of this revenue should remain relatively low compared to recent years.

This decline in equalization represents significant savings for the federal government. In this context, it is especially troubling to note the timidity of the reforms the federal government has proposed for the renewal of equalization. The proposed reform would result in additional revenues of barely $1.5 billion over five years for the provinces as a whole.

In this specific context, the First Ministers' discussions on health funding next summer hold a very significant risk for the provinces receiving equalization. The federal government could fund an increase in transfers for health from the savings it achieves in equalization. The provinces receiving equalization would be the big losers in this approach.

As Table 8 shows, this approach would produce substantial financial redistribution from the less affluent to the more affluent provinces. For instance, a rise in the CHST in Canada as a whole of $1 billion funded by an equivalent decline in equalization could result in a net shortfall of $489 million for the recipient provinces, including a loss of $151 million for Québec, a gain of $490 million for Ontario and Alberta and, of course, no cost for the federal government.

TABLE 8
IMPACT OF A RISE OF $1 BILLION IN THE CHST FUNDED BY AN EQUIVALENT DROP IN EQUALIZATION
(Millions of dollars)

	Rise in CHST	Decline in equalization	Net impact
Newfoundland and Labrador	16	- 76	- 60
Prince Edward Island	4	- 26	- 22
Nova Scotia	30	- 119	- 89
New Brunswick	24	- 121	- 97
Québec	**237**	**- 388**	**- 151**
Ontario	390	0	390
Manitoba	37	- 140	- 103
Saskatchewan	31	- 47	- 16
Alberta	100	0	100
British Columbia	131	- 83	48
Total	**1 000**	**- 1 000**	**0**

Source: Ministère des Finances du Québec.

This example clearly illustrates the importance of negotiating the corrections to equalization and federal health funding at the same time. This simultaneous discussion of the two issues is especially feasible since the discussions on the 2004 renewal of equalization are currently in full swing and the First Ministers have agreed to hold a conference on health this summer. This discussion is essential to ensure that provinces that receive equalization are in a financial position to deliver adequate public services, particularly regarding health, while keeping their tax system competitive.

4.3 Corrective measures to be implemented gradually

The proposals Québec has set out in this paper involve very large amounts. For equalization alone, the federal government should invest more than $5 billion to enable the program to adequately meet the needs of the provinces. The required additional contribution for health and social programs could reach more than $15 billion by the end of the decade.

TABLE 9
IMPACT OF PROPOSALS FOR HEALTH FUNDING AND THE RENEWAL OF EQUALIZATION, 2004-2005 TO 2009-2010
(Millions of dollars)

	Québec		Canada	
	Health	Equalization	Health	Equalization
2004-2005	471	2 872	2 000	5 212
2005-2006	814	3 009	3 471	5 461
2006-2007	1 533	3 143	6 570	5 703
2007-2008	2 093	3 282	9 018	5 957
2008-2009	2 796	3 431	12 116	6 226
2009-2010	3 532	3 585	15 390	6 505

Sources: Ministère des Finances du Québec; Department of Finance Canada; Conference Board of Canada.

Without an adequate correction of the weaknesses that afflict the equalization program, Québec and the other recipient provinces must maintain an additional tax burden of $5 billion to fund the public services they provide. This situation prevents the less affluent provinces from offering an environment as competitive as in the other provinces, thus depriving them of significant economic benefits and running counter to the interests of Canada as a whole.

However, Québec reiterates that correcting the substantial fiscal imbalance that currently exists between the provinces and the federal government must not push the latter back into deficit.

As the Commission on Fiscal Imbalance recommended in its March 2002 report:[7]

> *The Commission believes that the new division of taxation must not lead to federal government deficits, which is possible if the new division is implemented gradually and account is taken of actual federal government surpluses. Priority should be given to allocating future surpluses to the new division of tax room demanded in favour of the provinces.*

In this same constructive and pragmatic spirit, Québec believes that the Canadian federation must develop a strategy to correct the fiscal imbalance. In this context, Québec is seeking:

— in the short term, frank, honest and comprehensive discussions on the renewal of equalization and health funding. In view of the pressing need to act, such discussions should culminate at the meeting of First Ministers next summer and result in a firm undertaking by the federal government regarding these priorities;

— in the medium term, a thorough review of fiscal federalism with the prospect of a new division of financial resources in Canada.

7 Commission on Fiscal Imbalance, "A New Division of Canada's Financial Resources", March 2002.

APPENDIX: HOW EQUALIZATION WORKS

All federations of the western world, with the notable exception of the United States, have an equalization program. The constituents of a federation often have differing levels of wealth and, accordingly, very different capacities to collect revenue and carry out their constitutional responsibilities. Equalization, by offsetting all or part of these disparities, is a way for federated entities to improve their capacity to offer comparable levels of public services.

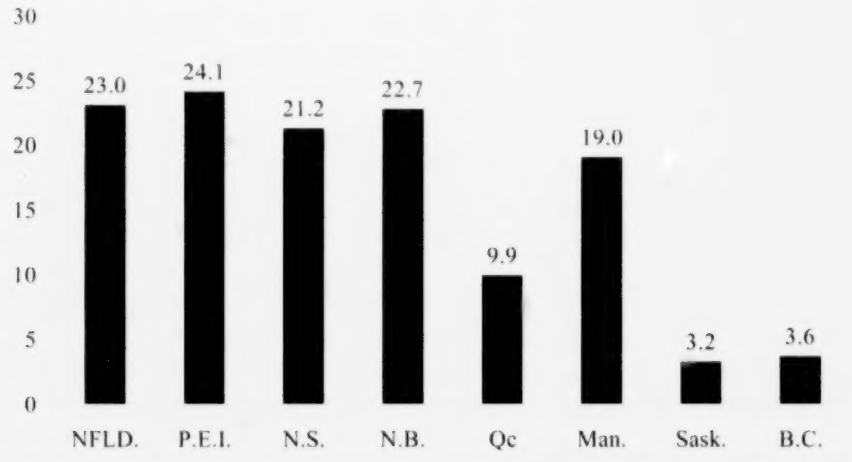
1. Canada's equalization program

In Canada, the equalization program was implemented in 1957. The principle of the program was entrenched in section 36(2) of the Constitution Act, 1982, which stipulates that:

> *Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*

In 2002-2003, the federal government paid equalization transfers totalling almost $10.3 billion to eight of the ten provinces. These transfers have a major impact on the capacity of many provinces to fund public services. Equalization payments represent almost one quarter of the budgetary revenue of the Atlantic provinces and close to 10% of that of Québec.

CHART A1
EQUALIZATION AS A PROPORTION OF PROVINCIAL BUDGETARY REVENUES, 2002-2003
(Per cent)



Sources: Provincial budgets; Department of Finance Canada.

2. Calculation of equalization entitlements

Provincial equalization entitlements[8] are calculated according to a formula that, broadly speaking, has not changed since 1982. There are three steps to the calculation of provincial equalization entitlements.

Step 1: ***measure the per capita fiscal capacity of the province and compare it with that of the provinces that make up the standard***

To determine equalization entitlements, the fiscal capacity of the provinces must be estimated for each of the 33 sources of revenue subject to the program.[9] Since the tax structure (definition of the tax base, tax rate structure, etc.) can vary from province to province, measurement of fiscal capacity for equalization is based on the notion of a *representative tax system* (RTS) of the various taxation practices of the ten provinces. A single tax system that reflects as far as possible the taxation practices in general use within the provinces is used to estimate the fiscal capacity of each province.

8 Equalization entitlements correspond to the amounts due to a province for a given year. Payments generally differ from entitlements because they reflect adjustments made to entitlements for prior years.
9 See Table A1.

A province's fiscal capacity for equalization can accordingly be substantially different from the tax base defined by its tax laws. For instance, the equalization program assigns a fiscal capacity for sales taxes to Alberta even though that province has chosen essentially not to use this tax field.

Once fiscal capacity has been established for each source of revenue subject to equalization of each province, it is compared with the fiscal capacity of the provinces that make up the standard. This comparison helps to determine for each source of revenue whether a province has an excess (fiscal capacity greater than that of the standard) or a deficiency (fiscal capacity below that of the standard).

The five provinces that make up the standard are Québec, Ontario, Saskatchewan, Manitoba and British Columbia. The standard accordingly excludes the province with the greatest fiscal capacity (Alberta) and the four provinces with the lowest fiscal capacity (the Atlantic provinces).

Step 2: ***compensate disparities in fiscal capacity compared to the standard***

Once the disparity between the fiscal capacity of a province and the five-province standard for each source of revenue has been established, equalization entitlements are obtained by multiplying this disparity by the average tax rate for all provinces, then by the province's population. Entitlements are negative if a province has an excess for a given source and positive if the province has a deficiency.

The calculation of equalization for a source of revenue is summarized in the following formula:

DIAGRAM A1
EQUALIZATION ENTITLEMENTS CALCULATION FORMULA

$$\text{Equalization entitlements of a province for a source of revenue} = \left(\text{Per capita tax base of provinces that make up the standard} - \text{Per capita tax base of the province} \right) \times \text{Average tax rate of the ten provinces} \times \text{Population of the province}$$

The terms in parentheses correspond to the fiscal capacity deficiency (excess) of the province for the source of revenue under consideration.

The following diagram shows the calculation of equalization for Québec for the tobacco tax base in 2003-2004. The fiscal capacity of this tax base is measured by the number of cigarettes consumed in each province.

DIAGRAM A2
CALCULATION OF QUÉBEC'S EQUALIZATION ENTITLEMENTS FOR THE TOBACCO TAX BASE, 2003-2004

Québec's equalization entitlements	=	(Per capita tax base of the standard	–	Per capita tax base of Québec)	x Average tax rate of the ten provinces	x	Population of Québec
– $190 million	=	(1 207 cigarettes/ person	–	1 432 cigarettes/ Person)	x $0.11/ cigarette	x	7 482 864 inhabitants

Source: Department of Finance Canada.

Accordingly, in 2003-2004, Québec had an excess for the tobacco tax base (225 cigarettes per person). Given the average tax rate of the ten provinces of $0.11 per cigarette and Québec's population of 7.5 million, Québec lost $190 million in entitlements for this source.

Step 3: ***combine the equalization entitlements of the 33 tax bases for each province***

The sum of the equalization entitlements for the 33 sources of revenue subject to the program gives the entitlements for a province. If this sum is less than zero, the province receives no payment. However, it does not pay anything out because equalization is funded from federal revenue and not by a direct contribution from the more affluent provinces.

The following table shows equalization entitlements for Québec, Ontario and all the eight recipient provinces in Canada for 2003-2004. Equalization entitlements for Québec are estimated at $3.8 billion. Note that Québec's fiscal capacity is higher than the standard for certain tax bases (corporate income tax, tobacco taxes and revenue from games of chance).

TABLE A1
EQUALIZATION ENTITLEMENTS FOR QUÉBEC, ONTARIO AND THE RECIPIENT PROVINCES, 2003-2004
(Millions of dollars)

Sources of revenue		Québec	Ontario	Recipient provinces
1	Personal income tax	1 744	- 3 144	4 238
2	Corporate income tax	- 301	- 584	1 016
3	Taxes on capital	118	- 237	333
4	General sales taxes	433	- 455	676
5	Tobacco taxes	- 190	30	-22
6-7	Taxes on gasoline and diesel fuel	207	- 111	69
8-9	Motor vehicle licences	30	- 18	24
10	Revenue from alcoholic beverages	32	- 13	31
14 to 22	Oil and gas resources	613	986	- 794
13-23-24	Other natural resources	- 59	699	- 599
26	Payroll taxes	202	- 438	590
27	Provincial and local property taxes	754	- 1 628	2 502
28-29	Games of chance	- 13	- 66	80
11-12-25-30-31-32-33	Other sources [1]	233	- 567	601
	Total	3 802	- 5 545	8 779

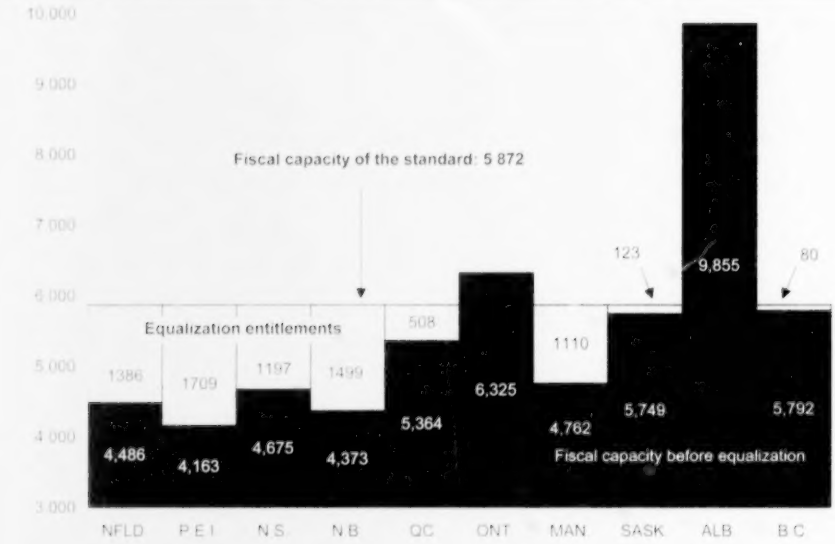
1 Including payments to Newfoundland of $7 million and to Saskatchewan of $104 million under the program's floor provision.

Note: The columns may not add up to the totals shown because of rounding off.

Source: Department of Finance Canada.

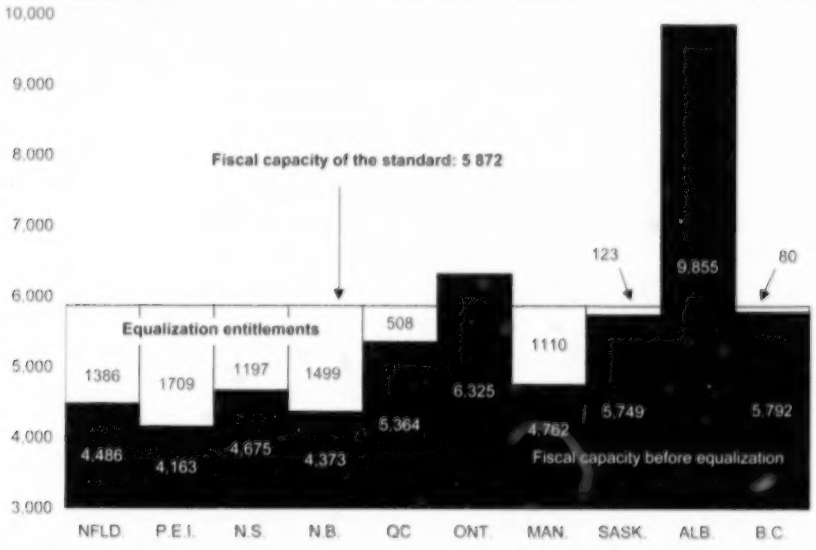
Overall, thanks to equalization, the fiscal capacity of the recipient provinces is raised to that of the five provinces that make up the standard, i.e. $5 872 per capita in 2003-2004, as shown in Chart A2. For the same year, only Ontario and Alberta had fiscal capacity greater than the standard. However, it is important to note that even after equalization, per capita fiscal capacity in Québec is still 5% below the average of the provinces and 40% below that of Alberta.

CHART A2
PROVINCES' FISCAL CAPACITY, BEFORE AND AFTER EQUALIZATION, 2003-2004
(Dollars per capita)



Note: Does not include payments to Newfoundland related to the floor mechanism.
Source: Department of Finance Canada.

CHART A2
PROVINCES' FISCAL CAPACITY, BEFORE AND AFTER EQUALIZATION, 2003-2004
(Dollars per capita)



Note: Does not include payments to Newfoundland related to the floor mechanism.
Source: Department of Finance Canada.

Finances
Québec